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## The vicious circles of recession and development prospects

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### Abstract

Almost four years after Greece's entry to a financial support programme, the Greek economy is still facing recession. The aim of this article is to analyse the interconnections between five vicious cycles of recession and highlight the country's development prospects. The five vicious cycles of the Greek economy are as follows: a) fiscal, b) internal devaluation, c) financial, d) psychological, and e) sociopolitical. These five vicious circles of recession must be seen in parallel with the adjustment policy applied. The results of this policy have created the preconditions for the maintenance of the recession. Also, other deficits of the adjustment policy and structural weaknesses of the Greek economy continue to limit the prospects of recovery for the Greek economy. We conclude with certain suggestions that might enable Greece to overcome the major obstacles to economic development.

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**Keywords:** Vicious cycle; Recession; Development

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### 1. Introduction

The international crisis of 2007 had major economic effects on European economic governance and European economies (Kotios and Roukanas, 2013). Greece experienced particularly negative effects as a result of the

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European economic crisis. The aim of this article is to analyse the main causes of the recession in the Greek economy lasting so long. First, we present the analytical framework, identifying five vicious circles which have exerted a synchronous recessive impact on the Greek economy. Employing this analytical framework, we highlight that the recession resulting from the Greek crisis arose through a combination of conditions. In Greece, there was a widespread crisis at three levels: economic, political and social. The main causes were public debt, low international competitiveness and economic, political and social structural weaknesses. In parallel, we analyse the adjustment policy applied and other deficits, together with the management of the crisis (at the national, European and international levels). The main consequences of the economic crisis have been the following: prolonged economic recession, the loss of invested capital and the reduction of productive capacity, the shrinkage of public and private investments, high structural and cyclical unemployment, the relocation of activities abroad, political instability, the erosion of social coherence, a new wave of migration of human resources, etc. Moreover, we discuss the structural weaknesses of the Greek economy as a cause of the crisis and an obstacle to growth. Finally, we conclude with our suggestions for the recovery of the Greek economy.

## **2. Analytical framework: the synchronous recessive impact of five vicious circles**

The theory of the vicious cycle of poverty was developed by Ragnar Nurkse to explain the limited possibilities for developing countries to create stable conditions for growth (Kregel, 2007). The analytical framework developed here identifies five vicious circles which have exerted a synchronous recessive impact on the Greek economy and aims to highlight the strong interconnections between the five vicious circles in the context of a developed country. The circles of recession in the Greek economy are not only economic, but also political and social. Thus, it is apparent that an economic crisis cannot be understood without considering the manifestations of the political and social context. The five vicious circles of the Greek economy are as follows:

- The fiscal vicious circle: a drastic cut in overall public expenses and increase in taxation leads to a reduction in active demand, the reduction of production and employment and a decrease in public and insurance/retirement fund income. These all lead to a further increase in public debt, a reduction in public expenses, an increase in taxation and so on.
- The vicious circle of internal devaluation: the reduction of wages reduces demand and production, increases unemployment, further reduces wages and public income and leads to new measures of internal devaluation and so on.
- The financial vicious circle: a credit crunch due to the level of public debt, a “haircut” in the context of private sector involvement (PSI), recession, the volatility of credit, the escape of capital abroad, the withdrawal of deposits for covering basic needs and weakness in obtaining liquidity from abroad all lead to a plunge in the financing of the economy, strengthening the recession, worsening bank liquidity and so on.
- The psychological vicious circle: the negative expectations for the future of the country and its economy cause a reduction in consumer demand (especially of durable goods) and of investments (Greek or foreign), which in turn strengthen the recession and aggravate expectations and so on.
- The political-social vicious circle: the economic crisis causes political instability and uncertainty, while at the same time disrupting social cohesion and increasing social tensions and clashes, causing a deterioration in the economic environment and investments, increasing losses in work hours due to strikes, reducing the effectiveness of crisis management, slowing down structural changes and finally boosting the financial recession, which in turn weakens political and social stability and so on.

## **3. The policy of adjustment applied and economic recovery**

Greece embarked on a trilateral mechanism of financial support involving the EU, the IMF and the ECB in May 2010. Greece could not borrow from the international markets to service its substantial debts because of the high interest rates. It also adopted an adjustment policy (Memorandum) with three main goals: fiscal consolidation, the rescue of the financial system and structural reforms. The basic tools of the adjustment policy, aimed at financial consolidation and increased competitiveness, were to cut expenses, increase taxes (towards fiscal consolidation), undertake internal devaluation (improve competitiveness), execute reforms (fiscal consolidation and increased

competitiveness) and implement privatizations (fiscal consolidation and increased competitiveness). Four years on from the adoption of the above-mentioned adjustment policy, the results differed from those expected (Roukanas, 2014).

The recession was expected, but not its duration and intensity (Table 1 and Table 2). The reasons for the persistence of its intensity are several. First, there is the reduced effectiveness of internal devaluation due to the increase in prices of other cost factors, but also due to structural weaknesses in substituting imports and increasing exports (the high degree of introversion of the Greek economy). Likewise, unit labour costs were reduced, but productivity also waned. Labour compensation is not the only factor in competitiveness (labour costs contribute, on average, to 21% of the prices of Greek tradable goods). For capital-intensive products and technology the labour costs are less significant. For internal devaluation to be successful, certain requirements need to be met: high national production of internationally traded labour-intensive products and services, an open economy, flexibility in internal production and the ability to substitute imports (Ioannou and Ioannou, 2014).

Table 1. Official GDP projections and outcomes for Greece

Years	Real GDP		Nominal GDP	
	Official projections	Outcomes	Official projections	Outcomes
2010	-4.0	-4.9	-2.8	-3.9
2011	-3.0	-7.1	-1.5	-6.1
2012	-3.0	-6.4	-2.8	-7.2
2013	-4.2	-3.5*	-5.4	-5.9*
*OECD projections				

Source: OECD (2013: 17)

Table 2. Macroeconomic fundamentals

Year	GDP at market prices (€ millions)	GDP per capita in PPS (EU28=100)	Unemployment rate (%)	People at risk of poverty or social exclusion (% of total population)	Real GDP growth rate	General government gross debt (as % of GDP)	GDP general government deficit (as % of GDP)
2002	156,614.6	90	10.3	-	3.4	101.7	-4.8
2003	172,431.1	93	9.7	-	5.9	97.4	-5.6
2004	185,265.6	94	10.5	30.9	4.4	98.6	-7.5
2005	193,049.7	91	9.9	29.4	2.3	100.0	-5.2
2006	208,621.8	92	8.9	29.3	5.5	106.1	-5.7
2007	223,160.1	90	8.3	28.3	3.5	107.4	-6.5
2008	233,197.7	93	7.7	28.1	-0.2	112.9	-9.8
2009	231,081.2	94	9.5	27.6	-3.1	129.7	-15.7
2010	222,151.5	88	12.6	27.7	-4.9	148.3	-10.9
2011	208,531.7	80	17.7	31.0	-7.1	170.3	-9.6
2012	193,347.0	75	24.3	34.6	-7.0	157.2	-8.9
2013	182,054.2	-	27.3	35.7	-3.9	175.1	-12.7

Source: Eurostat (2014a, 2014b, 2014c, 2014d, 2014e, 2014f, 2014g)

In Greece, the above requirements are lacking: there is only a small proportion of exports in relation to GDP (approx. 20%); 7.6% of total exports are labour intensive (2011); there is a low marginal propensity for imports (0.2); there is a lack of flexibility of prices downwards due to the lack of sufficient competition in the internal market for goods and services; there are increases in other costs (e.g. energy). Consequently, a relatively strong impact from internal devaluation can be observed on internal demand, but with very limited external positive effects (e.g. increase in exports, attraction of investment and the substitution of imports with national production). The structural reforms exerted a limited short-term positive influence on demand. There was no provision for an immediate opening up of the internal market for goods and services and weakness regarding competition. In the internal market, Greece has monopolistic and oligopolistic features that do not allow a considerable reduction of prices and an increase in demand. In parallel, in relation to final demand products, the intermediate products and the raw materials are defined externally (by multinational entities with Greece as price taker).

Greece has also faced resistance in the promotion of structural reforms, affecting the mid to long-term effect of structural changes; these have not been promoted sufficiently at the national level. The Greek state did not address the mitigation of the adjustment costs and support for the people most affected, thus increasing the reaction against adjustment. Whilst adjustment costs are borne by countries in crisis, the risk of financing is borne by the rest of the EU countries and the IMF. A more expansive policy on the part of the northern countries would have been more effective. There was no fair distribution of the tax burden and tax evasion, tax theft, corruption and the informal economy are some of the main reasons for the continuation of the crisis. The adjustment policy as it stands is to a great extent one that fights the symptoms and not the causes and thus – as might be expected – it has been ineffective. Greece has experienced foreign enforcement of the reforms rather than national “ownership”, causing internal reactions and resistance to adjustment, even against the most obvious reforms. There has been resistance against adjustment from organized interest groups (e.g. state-supported and protected sectors, public company syndicates, diverse groups in health care), aimed at keeping the redistribution of income in their favour, to the exclusion of other social groups and/or future generations. Current production costs are not outweighed by the expected gains in the minds of the citizens, leading to pessimism and negative reactions, a lack of vision for the future of the country and problems in communicating the reforms. Enforcers of the reforms (e.g. political parties) are often part of the problem and gain from the lack of reform; calculations of political costs also impede action. Finally, the privatization process had problems in its design and application, experiencing competition issues, etc. A change in the ownership of property is not enough: what is important is the investment plan of the new owner, even more so than the revenue generated by the sale.

#### 4. Other deficits of the adjustment policy

The adjustment programme also has certain weaknesses in that there was a deficit of strategic planning in the trilateral financial support mechanism: there was no countercyclical action, there were no developmental components; rather, all the policies were in effect directly or indirectly procyclical. The reform strategies identified focus more on macroeconomic targets, less on taxation and expense structures, the transfer of technology, support for investments, the distribution of income etc. No binding quantitative goals were defined for the real economy. Binding goals were established only for one partner (Greece), not for the Troika. As a senior economist, Gabriel Sterne, said of the IMF forecasts:

*“The Fund has never explained why it broke one of its most essential rules by supporting a lending programme to Greece from May 2010 that was inadequate to secure sustainability. That doesn’t just break the Fund’s own rules, it throws good money after bad. It not only delays the inevitable, but makes it worse. The Fund revised down its projections for the level of 2014 Greek GDP a mind-boggling 22 per cent in just 18 months (yes, over 1 per cent a month). With such errors, how on earth is it possible to produce the medium-term budgeting adjustment that is central to stabilising Greece?” (The Financial Times, 2014)*

There was no provision for industrial, agricultural or tourism policy, for the increase of exports or import substitutions, or for the increase/attraction of foreign direct investments (only through privatization). There were no changes in the National Strategic Reference Framework (NSRF) regarding productive, external investment, or a

renewed emphasis on transport infrastructure with a reduced impact on growth. In parallel, the policy for the substitution of imported energy, aimed at energy efficiency and saving, was not sufficient. Finally, the Greek state did not have the national funds to finance the social needs caused by the crisis, especially for combatting youth unemployment and long-term structural unemployment, as well as new poverty.

### 5. Structural weaknesses as a cause of the crisis and an obstacle for growth

The poor results of the adjustment programme are the result of certain structural weaknesses in the Greek economy that have not received proper attention and have proven very difficult to overcome during the crisis. The main structural weaknesses that can be seen as causes of the continued crisis are: the high correlation between structural weaknesses and the costs of the crisis, the low percentage of industry in total added value (8–9% vs. approximately 14% in the EU15), labour-intensive products (23% vs. 18% in the EU15), limited branches of technology (7% vs. 22% in the EU15), a prevalence of industrial products involving low labour skills (47% vs. 29% in the EU15) as against those requiring high skills (7% vs. 18% in the EU15) (Aiginger, 2013, pp.35–38).

Moreover, Greece has an inflated sector of non-tradable branches (e.g. construction, residential property, wholesale and retail trade, personal services, public sector); this is due in part to the low interest rate following entry to the Economic and Monetary Union (EMU) and in part to the NSRF. The results of the country's structural weaknesses have been the low level of extroversion in the economy, increased imports, reduced exports, current account balance deficits, etc. In parallel, Greece has seen a low degree of foreign investment (with the stock of foreign investment comprising 10% of GDP, the lowest in the EU, and annual inflows of only 1% of GDP), low indices in research, technology and innovation (the expenses of R&D constituting only 0.6% of GDP, compared to 2.1% in the EU 15) 8 patents/1 million residents in Greece as against an average of 137 patents/1 million residents in the EU15, and low indices for entrepreneurship (Aiginger, 2013, p.44). The regulatory framework is another issue, as the Greek market is one of the most regulated but least effectual, making it an interventionist but ineffective state. In past decades, there has been high consumption, but little investment (private consumption around 75% of GDP vs. private investment below 20% of GDP) (Aiginger, 2013, p.46). There has also been a negative attitude towards the phenomenon of globalization (42% of Greeks in favour, as against the EU average of 56% in favour and Scandinavian countries above 70% in favour). Finally, we can add high military expenses, far above the expenditure for R&D (2.3% of GDP vs. 0.67% GDP, respectively); a phenomenon noted only in Greece and Portugal (Aiginger, 2013, p.50).

### 6. Conclusions and suggestions for the recovery of the Greek economy

If the situation is left as it is, the country will have great difficulty escaping the vicious circles of the recession any time soon. The major challenge and a basic requirement of recovery is the breaking of the five vicious circles: fiscal, internal devaluation, financial, psychological and sociopolitical. Greece, as a member state of the EMU, has no sufficient national measures for anti-cyclical interventions (demand or investment policies) and consequently needs direct external support for the real economy in terms of investment. The NSRF is useful, but not sufficient to boost the economy (ca. annual inflows of 1.5% to 2% of GDP). Under the current conditions there is no room left for a national Keynesian policy (e.g. support for active demand and investment by the state through fiscal, monetary and income policy along EMU lines), but also due to the poor condition of the public economy. Inevitably, the only solution seems to be the improvement of the supply economy: an effective state, functioning markets, a positive business climate and the restructuring of production in favour of the tradables sector (industry and dynamic services). At the same time, however, direct foreign investment and an increase in the export of goods and services are required, as well as a social package of support for those on low incomes, which would also have countercyclical effects as it would reinforce internal demand. Public investment has wrongly been reduced; an increase in public investment is needed towards supporting the real economy.

What is needed is a total investment strategy, a comprehensive development plan and a vision for the future. As guidelines, we would suggest:

- An increase in investment.
- An increase in productivity rather than the reduction of wages.

- A new industrial policy: no low-cost goods, but an emphasis on innovation.
- An agricultural policy aimed at export-orientated agro-food production.
- The diversification and upgrading of the tourism sector.
- The development of dynamic services (e.g. transportation and transport, healthcare, R&D, services supporting production and new types of financial services (such as micro-financing, etc.).
- Extroversion: increased exports (e.g. export clusters), the inclusion of Greek companies in international chains and distribution networks, production and research.
- On the European side, the restructuring of the debt, the completion of the banking union and a Marshall-type project.

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